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R 181927Z NOV 76

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INFO AMEMBASSY CANBERRA

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PASS CEA, TREASURY, FRB

E.O.11652: N/A

TAGS: ECON, OECD

SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE (EDRC)
REVIEW OF AUSTRALIA

REF: EDR(76)29 (A) (B) CANBERRA 8324

1. SUMMARY: IN REFDOC CIRCULATED FOR NOVEMBER 24 EDRC
REVIEW OF AUSTRALIA, SECRETARIAT UNDERLINES CONSIDERABLE
SUCCESS GOA HAS HAD IN REDUCING INFLATION RATE THROUGH
RESTRICTIVE DEMAND MANAGEMENT POLICY AND MODIFICATION OF
WAGE INDEXATION SYSTEM. SECRETARIAT PROJECTS MODERATE
GROWTH OF AUSTRALIAN GDP THROUGH 1977 AND CONTINUED
DECELERATION OF INFLATION RATE UNDER ASSUMPTIONS OF
UNCHANGED DEMAND MANAGEMENT POLICY, MODERATION IN
NOMINAL WAGE INCREASES AND CONSTANT EFFECTIVE EXCHANGE
RATE OF AUSTRALIAN DOLLAR. HOWEVER, BECAUSE OF RESTRAIN-
ING INFLUENCE OF DEMAND MANAGEMENT POLICY AND OF
UNCERTAINTIES REGARDING GROWTH OF PRIVATE CONSUMPTION
AND BUSINESS FIXED INVESTMENT, SECRETARIAT ATTACHES
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CONSIDERABLE DOWNSIDE RISK TO ITS GROWTH FORECAST.

SECRETARIAT FEELS THAT SMALL TAX CUT COULD BE CONTEMPLATED AT APPROPRIATE TIME, BUT RECOMMENDS THAT GOA HANG TOUGH IN SHORT RUN. SECRETARIAT VIEW IS THAT GOA HAS WISELY DECIDED TO IMPROVE AUSTRALIAN COMPETITIVENESS BY REDUCING INFLATION RATHER THAN BY DEPRECIATION OF EXCHANGE RATE. ACTION REQUESTED: MISSION WOULD APPRECIATE COMMENTS/QUESTIONS WHICH COULD BE USEFULLY POSED AT EDRC REVIEW (PARTICULARLY AS REGARDS GOA EXCHANGE RATE POLICY, SEE PARA 7). FOR CANBERRA, MISSION WOULD WELCOME EMBASSY COMMENTS ON SECRETARIAT ANALYSIS AND RECOMMENDATIONS. END SUMMARY.

2. SHORT-TERM PROSPECTS; DOMESTIC OUTLOOK: AFTER ACCELERATION IN AUSTRALIAN GNP GROWTH RATE TO 6.5 PERCENT IN FIRST HALF OF 1976, SECRETARIAT SEES DECELERATION TO 2.6 PERCENT IN SECOND HALF OF THIS YEAR AND CONTINUED MODERATE GROWTH OF 3 PERCENT IN 1977. SECRETARIAT GROWTH FORECASTS FOR 1977 ARE BASED ON FOLLOWING ASSUMPTIONS: (A) GOVERNMENT EXPENDITURES WOULD FOLLOW GOA FY1976/77 (END JUNE 30, 1977) BUDGET ESTIMATES; NO DISCRETIONARY FISCAL POLICY SHIFTS WILL OCCUR IN SECOND HALF OF CALENDAR 1977; (B) MODERATELY RESTRICTIVE MONETARY POLICY WITH M3 INCREASING AT 10-12 PERCENT IN FY1976/77 AND SUBSEQUENTLY ADJUSTED DOWNRWARD AS INFLATION DECELERATES; (C) CONTINUATION OF PARTIAL WAGE INDEXATION (TWO THIRDS OF INCREASE IN CONSUMER PRICES PASSED ON TO WAGE INCREASES) AND NO WAGE DRAFT; (D) CONSTANT EFFECTIVE EXCHANGE RATE. SECRETARIAT SEES CONSIDERABLE DOWNSIDE RISK IN ITS GROWTH FORECAST FOR 1977. NOT ONLY IS DEMAND MANAGEMENT POLICY EXPECTED TO REMAIN RESTRICTIVE BUT, IN SECRETARIAT VIEW, CONSIDERABLE UNCERTAINTY SURROUNDS PROSPECTIVE EVOLUTION OF PRIVATE CONSUMPTION AND BUSINESS INVESTMENT. SECRETARIAT NOTES THAT EXPECTED DECELERATION OF INFLATION COULD LEAD TO FALL IN SAVINGS RATIO, WITH CONSEQUENT INCREASE IN PRIVATE CONSUMPTION, BUT THAT CONTINUED WEAKNESS IN LABOR MARKET (SECRETARIAT FORECASTS SMALL RISE IN UNEMPLOYMENT) COULD WELL HAVE OPPOSITE EFFECT. CONCERNING OUTLOOK FOR INVESTMENT, SECRETARIAT STATES THAT BUSINESS CONFIDENCE AND INTERNAL FINANCIAL POSITION OF FIRMS HAVE IMPROVED, BUT THAT EMPIRICAL EVIDENCE LIMITED OFFICIAL USE

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INDICATES THAT STRENGTH OF DEMAND (WHICH IS IN QUESTION NEXT YEAR) IS MORE IMPORTANT INFLUENCE ON INVESTMENT IN AUSTRALIA THAN ARE FINANCIAL VARIABLES. SECRETARIAT CONCLUDES THAT GOA SHOULD STAND READY TO APPLY PRUDENT DOSE OF FISCAL STIMULUS AT APPROPRIATE TIME. IN FOOTNOTE TO REFD0C, SECRETARIAT STATES THAT IT HAS RECENTLY BEEN INFORMED BY GOA THAT, IN CONTEXT OF TAX REFORM, REDUCTIONS IN DIRECT TAXES ARE IN OFFING.

3. PRICES AND WAGES: SECRETARIAT FORECASTS DECELERATION
IN INFLATION RATE DURING 1977, WITH ANNUAL RATE OF
INCREASE IN CONSUMER PRICES FALLING TO 7.5 PERCENT BY
END OF CALENDAR YEAR 1977 (VS 12.9 PERCENT INCREASE
ESTIMATED BY SECRETARIAT FOR 1976). SECRETARIAT
EMPHASIZES THAT CONTINUATION OF ONLY PARTIAL WAGE

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INDEXATION AND MAINTENANCE OF CONSTANT EFFECTIVE EXCHANGE
RATE ARE CRUCIAL ASSUMPTIONS UNDERLYING ITS PRICE FORE-
CASTS.

4. CURRENT ACCOUNT: SECRETARIAT OBSERVES THAT SIZE OF
AUSTRALIAN CURRENT ACCOUNT DEFICIT FORECAST FOR 1977
(\$U.S.900 MILLION) IS CONSIDERABLY BELOW HISTORICAL
AVERAGE WHEN MEASURED AS PERCENTAGE OF GNP, AND THAT
DEFICIT IS THEREFORE NOT A CAUSE FOR CONCERN. SECRE-
TARIAT FEELS THAT ON BASIS OF CURRENT ACCOUNT CONSIDERA-
TIONS ALONE GOA SHOULD HAVE NO DIFFICULTY IN MAINTAINING

EFFECTIVE EXCHANGE RATE OF AUSTRALIAN DOLLAR. SECRETARIAT ADDS, HOWEVER, THAT PRIVATE CAPITAL INFLOWS HAVE BEEN SLUGGISH BECAUSE (IN SECRETARIAT VIEW) OF DOUBTS CONCERNING AUSTRALIAN INTERNATIONAL COMPETITIVE POSITION, AND THAT GOVERNMENT HAS HAD TO STEP UP EXTERNAL BORROWING. SECRETARIAT URGES GOA TO CONTINUE TO IMPROVE COMPETITIVENESS THROUGH REDUCTION IN DOMESTIC INFLATION.

5. ECONOMIC POLICY: SECRETARIAT STRESSES THAT GOA'S LIMITED OFFICIAL USE

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MAIN POLICY PRIORITY IS REDUCTION OF INFLATION RATE, AND NOTES THAT FISCAL AND MONETARY POLICY STANCE HAS BEEN CONSISTENT WITH THIS OBJECTIVE. BUDGET DEFICIT IS BEING REDUCED; THIS WILL HAVE FAVORABLE IMPACT IN ITSELF AND WILL INCREASE PROBABILITY THAT GOA CAN ADHERE TO ANNOUNCED MONETARY POLICY GUIDELINES. (SEE PARA 2 ABOVE.) SECRETARIAT CONSIDERS GOA INCOMES POLICY AS ESSENTIAL INGREDIENT OF AUSTRALIAN STABILIZATION PROGRAM.

6. BASED ON ANALYSIS REFD0C, SECRETARIAT SUGGESTS THAT EDRC REACH FOLLOWING MAIN CONCLUSIONS:

(A) DEMAND MANAGEMENT POLICY MUST REMAIN CAUTIOUS; ADJUSTMENT OF WAGES TO INCREASES IN COST OF LIVING SHOULD REMAIN PARTIAL;

(B) MAINTENANCE OF DETERMINED ANTI-INFLATION POLICY LIKELY TO ENTAIL SHORT-TERM COSTS IN TERMS OF UNEMPLOYMENT; CONTINUATION OF MORE GENEROUS ATTITUDE (DEVELOPED IN RECENT YEARS) TOWARDS UNEMPLOYMENT BENEFITS WOULD THUS BE DESIRABLE;

(C) RISKS TO SECRETARIAT GROWTH FORECAST ARE ON DOWNSIDE. GOA SHOULD BE PREPARED TO INJECT SOME FISCAL STIMULUS (TAX CUT, NOT SPENDING INCREASE) AT APPROPRIATE TIME;

(D) GOA HAS WISELY DECIDED THAT NECESSARY IMPROVEMENT IN COMPETITIVENESS SHOULD COME THROUGH REDUCTION OF DOMESTIC INFLATION RATHER THAN THROUGH EXCHANGE DEPRECIATION WITH ITS HARMFUL EFFECT ON DOMESTIC INFLATION.

7. COMMENT: (A) SECRETARIAT NOTES THAT IN AUGUST 1976 GOA ANNOUNCED THAT 10-12 PERCENT GROWTH RATE OF M3 IN FY76/77 WOULD BE APPROPRIATE. SECRETARIAT ALSO STATES THAT GOA STUDIOUSLY AVOIDED USE OF TERM "TARGET" IN ANNOUNCEMENT, AND FEELS THAT IN OMISSION OF THIS TERM GOA WISHED TO EMPHASIZE THAT (I) GROWTH RATE COULD BE CHANGED IF CIRCUMSTANCES CHANGED; (II) VARIATIONS WITHIN

PERIOD COULD BE EXPECTED; (III) OTHER AGGREGATES,
INTEREST RATES, OR DOMESTIC CREDIT EXPANSION WOULD ALSO
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BE TAKEN INTO ACCOUNT. MISSION WOULD SEEK AUSTRALIAN

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VIEWS ON SECRETARIAT INTERPRETATION AND ON MONETARY
TARGETRY MORE GENERALLY; (B) SECRETARIAT CITES EMPIRICAL
STUDIES WHICH SHOW THAT, IN AUSTRALIA, GROWTH RATE OF
DEMAND IS MORE IMPORTANT DETERMINANT OF INVESTMENT THAN
ARE FINANCIAL VARIABLES (E.G. PROFITS, CASH FLOW, STATE
OF CORPORATE BALANCE SHEETS). MISSION WOULD ASK AUS-
TRALIAN REP TO COMMENT ON THIS QUESTION; (C) SECRETARIAT
STATES VIEW SLOWDOWN IN PRIVATE CAPITAL FLOWS TO AUS-
TRALIA LARGELY RESULT OF DOUBTS CONCERNING AUSTRALIA'S

INTERNATIONAL COMPETITIVENESS. MISSION PLANS TO RAISE THIS ISSUE AT MEETING, AND WOULD APPRECIATE EMBASSY VIEWS ON MAIN DETERMINANTS OF SUCH FLOWS; (D) DEVALUATION OF EFFECTIVE AUSTRALIAN DOLLAR EXCHANGE RATE WOULD OBVIOUSLY RENDER MORE DIFFICULT GOA'S ATTEMPT TO SECURE CONTINUED DECELERATION OF INFLATION RATE. HOWEVER, IF GOA STABILIZATION POLICY IS TO SUCCEED OVER MEDIUM TERM IT MUST BE BASED ON EXCHANGE EFFECTIVE RATE WHICH IS REALISTIC IN TERMS OF UNDERLYING ECONOMIC CONDITIONS. IN REF B EMBASSY NOTED THAT PRESENT DOLLAR HAS INCREASED WITH RECENT RUMORS OF DEVALUATION AND THAT GOA IS ATTEMPTING TO HOLD LINE UNTIL PRIVATE LIMITED OFFICIAL USE

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CAPITAL INFLOWS RESUME. THIS WOULD SUGGEST THAT CURRENT SITUATION IS CHARACTERIZED BY TEMPORARY LULL IN "NORMAL" CAPITAL INFLOWS AND BY SPECULATIVE CAPITAL OUTFLOWS, THAT DOLLAR IS NOT STRUCTURALLY OVERVALUED, AND THAT DEVALUATION WOULD THUS NOT BE CALLED FOR BY BASIC SITUATION AND TRENDS. INFORMAL CONTACTS WITH AUSTRALIAN OECD MISSION INDICATE THAT AUSTRALIAN REP TO EDRC WILL AGREE WITH SECRETARIAT VIEW THAT MAINTENANCE OF CONSTANT EFFECTIVE EXCHANGE RATE WOULD BE DESIRABLE. MISSION INCLINED TO SUPPORT THIS POSITION AND TO SUGGEST THAT PUBLISHED SURVEY BUTTRESS GOA EFFORTS TO HOLD LINE BY STRESSING THAT DEVALUATION DOES NOT APPEAR WARRANTED BY UNDERLYING ECONOMIC FACTORS. MISSION WOULD APPRECIATE WASHINGTON AGENCY AND EMBASSY VIEWS ON THIS QUESTION. KATZ

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Message Attributes

Automatic Decaptioning: X
Capture Date: 01 JAN 1994
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: ECONOMIC CONDITIONS, WAGES, INDUSTRIAL PRODUCTION, ECONOMIC REPORTS, ANNUAL REPORTS, PRICE INDEXES
Control Number: n/a
Copy: SINGLE
Draft Date: 18 NOV 1976
Decaption Date: 01 JAN 1960
Decaption Note:
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Authority: BoyleJA
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 28 MAY 2004
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1976OECDP34345
Document Source: CORE
Document Unique ID: 00
Drafter: n/a
Enclosure: n/a
Executive Order: N/A
Errors: N/A
Film Number: D760430-1127
From: OECD PARIS
Handling Restrictions: n/a
Image Path:
ISecure: 1
Legacy Key: link1976/newtext/t19761135/aaaabdou.tel
Line Count: 309
Locator: TEXT ON-LINE, ON MICROFILM
Office: ACTION EUR
Original Classification: LIMITED OFFICIAL USE
Original Handling Restrictions: n/a
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 6
Previous Channel Indicators: n/a
Previous Classification: LIMITED OFFICIAL USE
Previous Handling Restrictions: n/a
Reference: 76 CANBERRA 8324
Review Action: RELEASED, APPROVED
Review Authority: BoyleJA
Review Comment: n/a
Review Content Flags:
Review Date: 26 APR 2004
Review Event:
Review Exemptions: n/a
Review History: RELEASED <26 APR 2004 by hartledg>; APPROVED <16 SEP 2004 by BoyleJA>
Review Markings:

Margaret P. Grafeld
Declassified/Released
US Department of State
EO Systematic Review
04 MAY 2006

Review Media Identifier:
Review Referrals: n/a
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
Secure: OPEN
Status: NATIVE
Subject: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE (EDRC) REVIEW OF AUSTRALIA
TAGS: ECON, AS, OECD
To: STATE
Type: TE
Markings: Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 04 MAY 2006